

## Internal Revenue Service

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Third Party Communication: None

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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B01

PLR-153648-06

Date: March 19, 2007

### Legend:

X =

Y =

Products =

Date 1 =

Date 2 =

State =

A =

\$B =

Dear :

This letter responds to a request, dated November 14, 2006, written on behalf of X, requesting a ruling that the income received by X from a licensing agreement is not passive investment income within the meaning of section 1362(d)(2)(C)(i) of the Internal Revenue Code.

Facts

Based on the materials submitted and the representations made within, we understand the relevant facts to be as follows. X was incorporated on Date 1 in accordance with the laws of State. Also effective on Date 1, X made an election to be treated as an S corporation. X owns the trademarks for Products. X is now in the business of licensing its products.

Most recently, on Date 2, X entered into a Licensing Agreement with Y. Under the terms of the License Agreement, Y was granted the exclusive license to use the trade secrets, trademarks, service marks, and other property rights associated with Products for a term of A years. The License Agreement also provides Y with an option to purchase the proprietary rights associated with Products for a separate fee.

X represents that it has provided both substantial services and incurred substantial costs in creating, developing, and marketing Products. As a result of X's investment and extensive marketing campaign, X was able to increase the sales of Products to an amount in excess of \$B.

### Law and Analysis

Except as provided in section 1362(g), section 1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of section 1362, to be an S corporation.

Section 1362(d)(3)(A)(i) provides that an election under section 1362(a) terminates whenever the corporation (i) has accumulated earnings and profits at a close of each of three consecutive tax years, and (ii) has gross receipts for each of such tax years more than 25 percent of which are passive income.

Except as otherwise provided in section 1362(d)(3)(C), section 1362(d)(3)(C)(i) provides that the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Section 1.1362-2(c)(5)(ii)(A)(1) of the Income Tax Regulations provides that "royalties" means all royalties, including mineral, oil, and gas royalties, and amounts received for the privilege of using patents, copyrights, secret processes and formulas, goodwill, trademarks, tradebrands, franchises, and other like property. The gross amount of royalties is not reduced by any part of the cost of the rights under which the royalties are received or by an amount allowable as a deduction in computing taxable income.

Section 1.1362-2(c)(5)(ii)(A)(2) provides that "royalties" does not include royalties derived in the ordinary course of a trade or business of franchising or licensing property.

Royalties received by a corporation in the ordinary course of a trade or business of franchising or licensing property only if, based on all the facts and circumstances, the corporation (i) created the property; or (ii) performed significant services or incurred substantial costs with respect to the development or marketing of the property.

Conclusion

Based solely on the facts and representations submitted by X, we conclude that that X's income from the Licensing Agreement is not passive investment income under section 1362(d)(3)(C)(i).

Except as specifically ruled upon, this letter expresses no opinion concerning the federal tax consequences of the facts described under any other provision of the Code or regulations. Specifically, no opinion is expressed regarding whether X otherwise satisfies the S corporation eligibility requirements under section 1361, or that X made a timely election.

This letter is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Pursuant to the power of attorney on file with this office, a copy of this letter will be provided to X's authorized representative.

Sincerely,

David R. Hagund  
Senior Technician Reviewer, Branch 1  
(Passthrough & Special Industries)

Enclosures (2)

Copy of this letter

Copy of this letter for section 6110 purposes